

FINANCIAL SERVICES

This section addresses the financial services sector, which includes banks and credit unions, the securities industry, and insurance services.

BACKGROUND AND VULNERABILITIES

The financial services sector encompasses the broad range of banking, securities, and insurance services offered in this country. Institutions in this sector rely heavily, if not exclusively, on computers to transact business, keep records, and maintain security. Nearly every financial transaction in this country involves numerous computer functions. Without reliable systems, interest could be miscalculated, stock trades could vanish, and customers could have difficulty accessing their accounts or using their credit and debit cards. This high level of technological dependence makes the sector particularly vulnerable to the Y2K problem.

The financial services sector is also known for its interconnectedness and its dependence on third parties for safe and sound operation. For example, a bank depends on its borrowers to repay loans in order to avoid losses. A party to a derivatives transaction relies on its counterparty to perform. Financial institutions rely on funding vehicles provided by other institutions to maintain adequate liquidity. As a result of this reliance on third parties, institutions within the sector face two

types of risk. The first is primary risk, the risk that its own systems will fail and cause operational problems. The second is third-party risk, the risk that counterparts, borrowers, and clients will succumb to Y2K problems, fail to meet their obligations, and cause losses.

WHAT IS BEING DONE?

Over the past three years, the Committee has held hearings, attended briefings, and met with representatives of the financial industry to assess and promote Y2K compliance within the industry. Congress has also enlisted GAO to review the progress of the agencies. That work has continued over the past year.

The bank regulatory agencies provide quarterly reports to Congress in which they detail the readiness of the institutions they supervise and their efforts to manage the risks associated with the Y2K problem.

Committee staff meet and correspond regularly with government and industry representatives to promote compliance, share information, and provide advice on risk management.

The Committee continues to communicate with the bank regulatory agencies and the SEC as they develop plans for managing the problems associated with the small number of institutions that remain unprepared.

INVESTIGATING THE YEAR 2000 PROBLEM: THE 100 DAY REPORT

The federal bank regulatory agencies and the SEC have taken significant steps to communicate industry preparedness. These efforts include publishing information on Web sites, as well as community outreach. On September 17, 1999, government leaders responsible for overseeing the financial services sector held a summit in Washington to get the message out to the public.

The Committee will hold two hearings in October to assess the economic impact of the Y2K problem on the financial institutions sector. One will address the economic impact of Y2K. The other will be a field hearing in New York City on Y2K and its impact on just-in-time-inventory and the business cycle.

STATUS

By all accounts, the financial services sector in the U.S. is well ahead of many other business sectors. Government regulatory agencies continue to take steps to ensure compliance and plan for contingencies.

Financial Institutions and their Regulatory Agencies

The Federal Financial Institutions Examination Council (FFIEC) has taken the lead in coordinating Y2K examination policy for the federal bank regulatory agencies, and has established a number of milestone dates by which financial institutions were expected to complete various stages of Y2K remediation and risk management processes. The FFIEC

set June 30, 1999, as the date by which financial institutions were to have completed testing of their mission-critical systems, substantially completed implementation of mission-critical systems, and substantially completed the development of business resumption contingency plans.

The bank regulatory agencies report that, as of June 30, 1999, more than 99% of banking institutions in the U.S. have achieved ratings of satisfactory or higher in their Y2K preparation. Approximately 99% of FDIC-insured institutions had completed their testing and submitted contingency plans by the milestone date. The regulatory agencies plan to conduct on-site reviews at all institutions that failed to meet the deadline. The agencies remain optimistic, however, that many of the institutions that failed to meet the deadline will be able to complete their work early in the third quarter. Reports detailing the compliance of financial institutions may be found on the Committee's Web site.

The bank regulatory agencies have initiated numerous enforcement actions against institutions that have failed to meet established milestones. Many of the institutions that have been the subject of supervisory actions over the past two years have repaired their systems and are now included within the banks rated "satisfactory." The agencies are closely supervising institutions that continue to lag behind in Y2K preparation and will use their enforcement authority to manage the risks associated with these institutions.

Credit Unions

Credit unions are regulated by the National Credit Union Administration, which is part of the FFIEC and follows the same Year 2000 examination procedures. As part of the June 30, 1999, target date, 98% of all federally-insured credit unions, representing 10,585 credit unions and 96% of assets, had met the testing requirements. Those credit unions that did not meet the June 30 testing milestone and did not complete testing by July 2 received either an administrative action or a waiver of administrative action based on individual circumstances and the credit union's ability to meet future milestone dates. The NCUA will continue to monitor compliance and review business resumption, liquidity, and contingency plans.

Cash Availability

The Federal Reserve has embarked on a program to ensure that there is sufficient cash available to meet any unusual demands in the period around the century date change. Federal Reserve Board Governor Edward Kelley recently testified that, despite the Federal Reserve's view that consumers do not need to hold extra cash over the century date change, it will *"provide currency to the public as demanded and will be prepared to fulfill its responsibility whatever the level of demand might be."*

"THE SECURITIES INDUSTRY WAS ON TO THIS SUBJECT (Y2K). THE POINT BEING, IF YOU ARE ON THIS, YOU CAN HANDLE IT. IT IS THOSE WHO AREN'T WHO WILL LEAVE US IN THE GREATEST TROUBLE."

--SENATOR MOYNIHAN

On July 20, 1999, the Federal Reserve announced its plan to establish a Century Date Change Special Liquidity Facility. This is a program that will provide funding to depository institutions from October 1, 1999 through April 7, 2000 in an effort to help depository institutions commit to supplying loans to other financial institutions and businesses through the rollover to the new century. Loans from the special facility will be at an interest rate 150 basis points higher than the federal funds rate and will be subject to collateral requirements that are the same as those for regular discount window loans.

The Securities Industry

The securities industry, under the leadership of the SEC and the Securities Industry Association (SIA), has led the financial services sector in remediation, planning, and testing. The securities industry completed most of its remediation efforts by the end of 1998, and the SIA has organized extensive street-wide testing, which has been underway since the beginning of the year. The SEC has described the first phase of testing as "overwhelmingly successful" with almost 400 brokerage firms, mutual funds, securities exchanges, and clearing agencies participating.

At the urging of Senator Bennett, the SEC issued an interpretive release on July 29, 1998, requiring issuers

of securities to disclose material information on their Y2K readiness. The SEC staff closely monitors these disclosures and has communicated directly with issuers with inadequate disclosures. As a result of these efforts, the SEC has found an improvement in both the quantity and quality of disclosure.

The SEC staff has also reviewed the Y2K disclosures made by the largest investment company groups representing more than 81% of investment company assets as of December 31, 1998. All 50 groups had made Year 2000 disclosures.

Finally, the SEC's own mission-critical systems are compliant. Most recently, the SEC's EDGAR system, which provides investors with Internet access to the filings of publicly traded companies, was certified compliant.

Payment Systems

The CHIPS system recently conducted extensive testing of its payment systems throughout the world for Y2K compliance. The results of the testing showed that the CHIPS systems are Y2K compliant and will be able to successfully maintain operations over the century date change.

EXPECTATIONS

The bank regulatory agencies are confident that financial institution customers will be able to conduct business as usual both before and after January 1, 2000, and that there is no need for a banking holiday over the century date change. While various financial and trade groups have considered whether a banking holiday on December 31 would ease potential disruptions, the Federal Reserve Board issued an advisory on January 28, 1998 stating that the Reserve Banks will adhere to a standard schedule this year and remain open on December 31, 1999.

While progress within the securities industry is excellent, a small number of firms have lagged behind in Y2K compliance. The SEC is continuing to monitor those firms closely and has taken enforcement action against 37 broker-dealers, 13 investment advisers, and 15 transfer agents for failing to report

on their Year 2000 readiness. In the case of broker-dealers and transfer agents, the SEC has established a rule that would require every firm not Year 2000 compliant by October 15, 1999, to cease doing business.¹

The regulators will continue to struggle with the question of how to manage the very small number of institutions that remain unprepared. The Committee staff believes the

"THE MAIN POINT THAT I HOPE TO IMPRESS UPON THIS COMMITTEE IS THE NEED FOR THE PRESIDENT, DOD, AND THE SECRETARY OF THE TREASURY TO EXERT LEADERSHIP IN ALERTING THE WORLD TO THE Y2K PROBLEM. . ."

***- JOHN WESTERGAARD
TESTIMONY IN NEW YORK
CITY BEFORE SENATORS
MOYNIHAN & BENNETT***

regulators will have to closely monitor the progress of these institutions.

CONCERNS

While the overall preparedness of the financial services sector is high, the industry remains susceptible to secondary risks. These risks are considerable and will require significant management attention in the months that remain before the end of the century.

- The financial services sector continues to assess the preparedness of its counterparties and borrowers (in the U.S. and abroad) in an effort to assess this risk. A bank with perfectly compliant computer systems still faces Year 2000 risk if its borrowers or counterparties fail to meet their obligations as a result of the Y2K problem. Credit Suisse First Boston recently downgraded four major U.S. banks to the unusual "sell" rating, citing Y2K risk as a major concern. The analyst for First Boston cited concerns related to secondary risks, such as credit risk, counterparty risk (especially foreign counterparties), and economic risk. The analyst reported that while banks have prepared their own systems, third party defaults and general economic stress are likely to have a negative impact on earnings.
- Regulators are urging financial institutions to communicate their preparedness to their customers in order to reduce the potential

for panic at the end of the year. This communication is essential to managing the risks associated with the Y2K problem. If customers have accurate information about the readiness of the sector, they will act in a more prudent manner. The information is also important as the industry attempts to neutralize the volumes of inaccurate, misleading, and inflammatory information published in Y2K books and Web sites.

- Questions remain as to what extent publicly-traded companies have disclosed their Year 2000 risks to their shareholders. In July 1998, the SEC issued a legal interpretation requiring companies to disclose material information about their Year 2000 readiness. Most companies have included a Year 2000 disclosure in their filings, but questions have been raised about the quality of those disclosures. Because the SEC's interpretation leaves it to the issuer to determine what is material, most filings do not contain sufficiently detailed information about the stages of readiness or the efforts to manage third-party risks. When the Committee asked 1,000 companies to provide that information, only 39% responded. If publicly-traded companies have failed to adequately disclose their readiness and problems ensue, there will likely be a significant negative impact on the stock market and the world economy as investors lose confidence.

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- Most studies have shown that countries in other parts of the world continue to lag behind the U.S. in Y2K remediation and risk management efforts. Financial institutions, which are a vital link in the global economy, are particularly susceptible to risks from failures abroad. The regulators have urged institutions to assess their risk exposure. This has been a difficult process, however, and to a large extent the risks remain unknown. Financial institutions subject to international risk must have contingency plans to manage this risk.

¹ "Operational Capability Requirements of Registered Broker-Dealers and Non-Bank Transfer Agents and Year 2000 Compliance," March 8, 1999.